Testimony of Steve Layton

President and Chief Executive Officer

Equinox Oil Company

Houston, Texas

before the

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Committee on Commerce

Subcommittee on Energy and Power

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Thank you Mr. Chairman for the privilege to appear before you and the Energy and Power Subcommittee here in Dallas. You are to be complimented for your efforts to examine this highly complex and politically charged subject of electric restructuring. The United States economy can no longer afford to labor under our antiquated system of providing electricity service. It is time to allow all classes of electricity consumers to benefit from a competitive electricity marketplace.

Introduction

My name is Steve Layton and I am president and chief executive officer of Equinox Oil Company, one of a small number of large, privately held independent oil companies successfully operating today. I am a third generation independent oil producer based in The Woodlands, Texas. I also currently serve as president of the National Stripper Well Association (NSWA) and as a governor on the board of the Independent Petroleum Association of America (IPAA).

Equinox Oil Company has 180 employees and operates approximately 2,000 wells in the states of Kansas, Oklahoma, Arkansas, Louisiana, Illinois and Indiana. Ninety percent of the wells we operate are marginal wells. Last year our company spent over $3 million on electricity.

Discussion and debate over electric restructuring is occurring all across the country. In fact, their is an effort underway in the Texas legislature to pass an electric restructuring bill. This effort has been spurred by Governor Bush's endorsement of customer choice in the electricity market. Little more than a year ago no one at my company gave much thought to electric restructuring. Today, we are examining the risks and opportunities that electric restructuring represents to our company and small independent oil and gas producers.

Profile of the Independent Producer

Independent producers are a proud, dynamic, and vital economic force within this country. The independent producer is typically a small company with an average work force of 10-13 and average production of 221 barrels of crude oil and 2.5 MMcf per day. Together independents drill 85 percent of the domestic wells and produce about 45 percent of the crude oil and 66 percent of our nation's natural gas. Electric restructuring is important to both the oil and gas side of our business.

The Producer as Consumer

Our industry has a unique perspective on electric restructuring. We not only produce the natural gas used to generate electricity, but our oil production makes us major consumers of electricity. Oil producers are an important part of the power grid. Our demand is very steady, day in and day out. The cost of electricity is an especially crucial factor to producers operating marginal wells, given that electricity is often a producer's largest single production expense. In fact, some oil wells, such as those with a high water cut and others associated with heavy oil production, may spend upwards of two-thirds of their operating costs just on electricity.

To make my point, I want to share with you some information about electricity usage at two fields currently being produced by my company. The first field is located in Southwest Louisiana. Current crude oil production stands at about 100 barrels per day, with estimated reserves of 700,000 barrels. The average monthly direct lease operating expense is $55,000. Electricity costs account for $10,000, or 18 percent of direct lease operating expenses. We pay the local public utility a kwh rate of $.12. After labor, electricity costs are the second largest component of total direct operating expenses for this property.

The second illustration involves a field in the Illinois Basin, located in Southeast Illinois. Current crude oil production is about 300 barrels per day, with estimated reserves of 2.3 million barrels. The average monthly direct lease operating expense is $110,000. Electricity costs account for $27,000, or 25 percent of the lease operating expense. We pay the local public utility a kwh rate of $.09. Electricity is the number one component of total direct operating expenses for this field.

In March 1997, IPAA conducted a survey of oil producers' electricity costs and usage. The survey was conducted at the request of House Commerce Committee. We received responses from 37 member companies operating in 12 of the 33 producing states in the continental U.S. The survey revealed the 1995 and 1996 median average expenditure on electricity amounted to $166,953, representing 9.5 percent of total operating costs. Another survey conducted by the Oklahoma Commission on Marginally Producing Oil and Gas Wells revealed that electricity costs account for approximately 12 percent of total operating costs, the largest expense in operating a lease.

In 1994, the National Petroleum Council released a study of our country's 450,000 endangered marginal wells. I want to point out that marginal wells, which are defined as those producing 15 barrels of oil per day or less, account for approximately 20 percent of all crude oil produced in the lower-48 states and contribute approximately $20 billion annually to the U.S. economy. One of the study's primary recommendations for maintaining these important contributors to the nation's energy supply and economic security was electricity/utility reform.

It’s easy to see that electricity costs may determine whether an oil well is economic or not. It goes without saying that oil producers support a competitive, efficient, and equitable electricity industry. If electricity costs can be reduced, our nation’s marginal reserves can be produced to their fullest potential. Producers look forward to choosing their service provider, having better rates for all consumers and regions, and even forming electric user cooperatives.

The Independent Producer of Natural Gas

On the gas side we already face challenges, and we do not want electric restructuring to add to them. Natural gas imports have also been steadily growing, constrained only by the capacity of north/south pipelines. Gas imports have doubled in 1996 from the 1.5 Tcf level of 1990 to about 3 Tcf or 13 percent of U.S. supply. That means that cost cutting by independents will have to continue if they are to compete with imported gas supplies and other fuels such as coal.

Independent producers met a growing market in the face of declining prices as a result of significant efforts to cut costs and increase efficiency through the deployment of technological advances. One example of this is that IPAA members projected a 73 percent increase in seismic budgets for 1996. However, there is a strong likelihood that technological efficiency gains will level off and that other production costs will escalate, creating even greater pressure on producer netbacks. As fuel markets converge, and as the laws and regulations governing electricity are restructured, Congress must make certain that independent producers are given a fair opportunity to compete.

The Independent Perspective on Restructuring

IPAA and its cooperating state and local producer associations, which together represent the vast majority of independent producers operating in the U.S., have agreed upon certain fundamental principles with respect to electric restructuring. While these principles are fairly broad and general, they do underscore the independent producer perspective on a variety of the relevant issues. The position statement emphasizes several key points. As producers of natural gas and consumers of electricity we support restructuring, competition and customer choice so long as certain conditions are met. These conditions include the following: 1) there needs to be a comprehensive rather than a piecemeal approach; 2) a time certain for adoption by the states of plans implementing a competitive framework is required; 3) the environmental playing field should be level with fuel-neutral emissions standards; and 4) the sanctity of existing contracts must be honored. In addition, independent producers want to see all electricity consumers, large and small, gain access to competitive rates and service.

We are still examining other aspects of restructuring. Independents with marginal well production in rural locations could be adversely affected if retail competition is not mandated for all markets. Many producers are concerned that rural electricity consumers could get stuck with higher rates while large industrial consumers are able to effectively shop for low-cost power. If rural electric cooperatives are excluded from deregulation many marginal well operators will not enjoy the benefits of competition. In addition, the States should play a large role in examining retail competition and electric restructuring in the context of economies of their respective situations. We anticipate that positions on these and other issues will be further refined as the policy debate progresses.

Independent producers are well aware of the damage that can be wrought by senseless rules, regulations, and laws. The natural gas industry has only recently begun to climb out of the hole created by Congress when it passed the Fuel Use Act which prohibited the use of natural gas for various purposes, including its use as a fuel to generate electricity. Not until last year did annual natural gas consumption approach the 22 Tcf level which was achieved in the 1970’s. Indeed, it was over twenty years ago that independent producers warned Congress of the danger of controlling the prices and limiting the uses of natural gas. As we have all witnessed over these twenty years, when the market is allowed to work free of undue governmental interference and intervention, it is without a doubt good public policy.

There are two schools of thought on the impact which restructuring will have on the gas market. One group thinks that gas will be hurt as low cost coal captures the market and as the redundant coal capacity is more fully utilized. Others, however, believe that gas will be able to hold its own in the electric generation market because it is clean-burning and a very efficient fuel when used by combined cycle turbines. Both are probably right, the question is when.

Many in Washington are fond of saying that natural gas is the fuel of the future. The trouble is, that nobody seems ready to make it the fuel of the present. It is our hope that so long as fuel choices are not distorted by misguided policy choices, natural gas will be able to thrive in this marketplace in the not too distant future. The capital cost requirements to build a modern gas turbine plant are significantly lower than those for other fuels. In addition, a new gas plant is relatively benign from an environmental standpoint. New gas plants emit Nox at a rate of twenty to thirty times lower than that of an old coal plant, CO_2 levels of about a third of coal, and are virtually free of SO_2 emissions. However, requiring new gas plants to meet more stringent air quality standards than existing coal plants amounts to nothing more than a subsidy for one fuel at the expense of another. There must be a direct linkage between restructuring and the implementation of a fuel neutral environmental policy.

Even worse, some have proposed that certain fuels, such as renewables, be provided with outright preferences in the form of mandated usage. Given that all fuels will be competing for market share, there is no rationale for providing some with the legislative muscle to grab markets. In fact, this tinkering is likely to come directly at the expense of the natural gas industry, as utilities continue to baseload power generated by existing coal and nuclear facilities and back out natural gas-fired generation. The whole purpose of this restructuring exercise is to arrive at a more efficient market driven economy. There is no place for subsidies or preferences in this restructured world.

There is a desire by producers to capture a larger piece of the value chain given that over the last ten years average wellhead prices have come down around 37 percent while the residential burnertip price is virtually unchanged. Even when the unprecedented prices of this past winter are factored in, wellhead prices are still down from 1985 levels and the residential burnertip is up. There is a possibility that this may occur as gas and electricity markets become increasingly commoditized and as wholesale and retail competition take hold. The onset of competition may well create a climate allowing producers to forge strategic alliances with others involved in downstream gas and electric markets. Gas by wire through merchant power plants and distributed power generation may offer better returns to the gas industry and gas producers than selling and transporting spot supplies through mega-marketers. However, for natural gas to have an even chance at the growing electric market there needs to be open access and customer choice throughout the value chain, from wellhead to burnertip. Currently, competition and unbundled services exist only at the wellhead and interstate pipeline, but hit a brick wall in the form of an LDC city-gate franchise boundary. I recognize that the focus of this field hearing is on retail electricity competition. However, it makes little sense to attempt to address the retail electric business while at the same time turning a blind eye toward the retail natural gas business. Natural gas can compete for the electric market, so long as Congress does not once again tip the scales against gas producers.

Finally, with respect to the recovery of stranded costs, while IPAA has not taken a formal position, I would note that the regulatory compact has not protected producers in the past when our contracts were restructured and even more recently when the gathering systems upon which we rely to move our gas into the interstate grid were deregulated by the Federal Energy Regulatory Commission through the artifice of pipeline spindowns and spinoffs. In both cases there were neither captive ratepayers to allocate costs to nor a federal safety net. Rather, producers were forced to absorb these restructuring costs directly. No doubt there will be costs involved in transitioning from an industry characterized by monopoly and rigidity to one that is competitive and flexible. Those costs need to be allocated fairly and responsibly and in a manner that does not delay the onset of true competition.

Conclusion

Efforts to restructure the electric industry are under way in Washington and in the far reaches of states like Texas. The legislation that has been introduced in both the House and Senate would bring about drastic changes to the last great monopoly. Competition is coming to electricity markets just as it has come to natural gas production and transmission. I would just ask that you remember the tremendous impact that your actions can have on the ability of thousands of independent producers, particularly the marginal well producer. Independent producers look forward to working with the Committee as you move forward with legislation to deregulate the electric industry. I would be happy to answer any questions the Committee may have.